

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Ducheny Analyst: Marion Mann DeJong Bill Number: AB 490

Related Bills: _____ Telephone: 845-6979 Introduced Date: 02/18/1999

Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Headquarters Operation Credit

SUMMARY

This bill would create a new headquarters credit equal to 6% of the eligible costs paid or incurred by a qualified taxpayer that either locates a new corporate headquarters in this state or maintains or expands an existing corporate headquarters in this state.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately and would apply to income years beginning on or after January 1, 2000, and before January 1, 2005.

LEGISLATIVE HISTORY

AB 1313 (1993/94), AB 556 (1995/96).

SPECIFIC FINDINGS

Current state and federal laws do not provide credits specifically for corporate headquarters.

Existing **state and federal laws** generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or as investment property. The property must have a useful life of more than one year and includes equipment, machinery, vehicles and buildings, but excludes land. Property is assigned to specific classifications related to the number of years of its useful life. The property then may be depreciated over the number of years of its useful life (recovery period).

Existing **state and federal laws** allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business (e.g., employee wages and benefits), unless those expenses are otherwise required to be capitalized.

Existing **state law** allows taxpayers to use various credits against tax such as the Manufacturers' Investment Credit (MIC), the research and development credit and economic development area sales or use tax credits and hiring credits.

MIC

The MIC allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

Board Position:

_____ S	_____ NA	_____ NP
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_____ N	_____ OUA	_____ <u>X</u> PENDING

Department Director

Date

Gerald Goldberg

2/23/1999

A qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes in the Standard Industrial Classification (SIC) Manual. For purposes of the MIC, "qualified property" generally means property that is purchased or leased for use in the manufacturing, processing, refining, fabricating, or recycling process, or for use in research and development. The MIC does not apply to real property except "special purpose" buildings for specified classes of taxpayers. The MIC does not apply to office furniture, fixtures and equipment.

Sales or Use Tax Credits

The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified property for exclusive use in an economic development area¹ (except an MEA). The amount of the credit is limited to the tax attributable to economic development area income.

Hiring Credits

A business located in an economic development area may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an economic development area and must meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the economic development area and at least 50% must be performed inside the economic development area. The taxpayer may claim as a credit up to 50% of the wages paid to a qualified employee against tax imposed on economic development area income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (202% of the minimum wage for certain aircraft manufacturer employees within the Long Beach Enterprise Zone).

This bill would create a new credit equal to 6% of the eligible costs paid or incurred by a qualified taxpayer that either locates a new headquarters operation in this state or maintains or expands an existing headquarters operation in this state.

"Qualified taxpayer" means any taxpayer that, during the income year, meets both of the following requirements:

1. Locates a new or maintains an existing headquarters operation in this state by doing any of the following:
 - building or purchasing a new headquarters building;
 - leasing a new headquarters building, or renewing a lease of a headquarters building;
 - expanding an existing headquarters building by at least 25% through new building construction or acquisition, or the acquisition of additional leased space.
2. Employs at least 100 headquarters employees at the headquarters building. The taxpayer must employ the 100 headquarters employees within 12 months after any of the following applicable events:

¹ Economic development areas include Enterprise Zones, Local Agency Military Base Recovery Areas (LAMBRAs), Targeted Tax Areas (TTAs) and Manufacturing Enhancement Areas (MEAs).

- receipt of a certificate of occupancy following construction of a new or expanded headquarters building.
- close of escrow on the purchase of a headquarters building.
- the earlier of the date of occupancy or commencement of a lease term for the headquarters building.

"Eligible costs" means costs paid or incurred by the qualified taxpayer which are included in the basis of the qualified property placed in service by the taxpayer during the income year. Eligible costs must be paid or incurred in connection with a headquarters building located in this state.

"Qualified property" includes either of the following:

- real property or a portion of real property, excluding land, located in this state and used for a headquarters building; or
- depreciable tangible personal property (Internal Revenue Code (IRC) Section 1245(a)(3) property) used primarily in the headquarters building exclusively for the headquarters operation or exclusively for research and development activity. Such property includes office furniture and equipment, fixtures, computer equipment and telecommunications equipment.

Leased property that is qualified property qualifies for the credit. For qualified tangible personal property, eligible costs include the amount properly capitalized for tax purposes on the books and records of the qualified taxpayer. For qualified real property, the lease payments which are eligible costs are only those costs paid or incurred during the income year and include the ratable payments for a period of up to 10 years beginning with the commencement date of a new or renewed lease. Eligible costs would not include lease payments properly associated with taxes, insurance and repairs, except to the extent that those costs would properly be capitalized if the lessee owned the qualified property.

"Headquarters building" means the **portion** of the physical premises located in this state which is occupied exclusively by a headquarters operation or a headquarters operation and research and development activity. The headquarters operation and research and development activity must occupy at least 75% of the total physical premises of a building or buildings.

"Headquarters operation" means a location or office in this state for which all of the following apply:

- It is the location or office of a corporation engaged in a multistate or multinational business.
- It is a location or office at which either (1) the taxpayer's managerial, professional and administrative staff predominately work at and perform a majority of the headquarters functions; or (2) is the commercial domicile of the taxpayer.
- It is the location where the headquarters functions are performed. "Headquarters functions" means the planning, directing, and controlling of substantially all aspects of the qualified taxpayer's subsidiaries, multistate or multinational operations, and exercising final authority over all matters within its area of operations.

- It is the location or office at which at least an average of 100 headquarters employees are employed each month during the income year.

"Headquarters employee" means an employee who satisfies all of the following:

- An employee, as defined in Section 621 of the Unemployment Insurance Code, who is employed, without a scheduled termination date, and who is neither temporary nor seasonal.
- An employee who meets any of the following: (1) provides substantially all of his or her services in the headquarters building for the taxpayer, in the capacity of the taxpayer's managerial, professional, and administrative staff, and does not provide services to the taxpayer's clients or customers; (2) provides substantially all of his or her services in the physical premises of a building or buildings occupied by a headquarters operation, in the capacity of the taxpayer's research and development staff; or (3) an employee engaged in manufacturing activities.
- A full-time employee (as defined).
- An employee who is eligible for unemployment benefits under the Unemployment Insurance Code and under the terms of any benefit plans.

A taxpayer renewing a lease must increase the amount of leased space by 25% and increase, by at least one, the number of headquarters employees to qualify for the credit in connection with the renewal of a lease of a headquarters building.

If more than one credit would be allowed for eligible costs, the taxpayer must make an election as to which credit would apply. If the credit exceeds tax, the excess would be carried over to reduce tax in the succeeding 10 income years.

This credit would be recaptured if during any of the five income years beginning with the first income year after the taxpayer becomes a qualified taxpayer, the taxpayer's total full-time employment of headquarters employees falls below 100.

The amount of credit recaptured is 50% of the credit for the first year of noncompliance and 25% of the credit in any two succeeding years.

In addition, any credit attributable to qualified property would be fully recaptured if that property is removed from this state, is disposed of to an unrelated party, or is used for any purpose not qualifying for the credit within three years from the date the taxpayer becomes a qualified taxpayer.

Policy Considerations

This bill would raise the following policy considerations:

- This bill would count manufacturing employees who work in California as headquarters employees. However, the bill does not require the manufacturing employees to provide services in the physical premises of a building or building in which the headquarters functions are performed. Thus, if a taxpayer's business activities are located in two buildings, one building with 10 administrative and/or research and development employees located in San Diego and one building with 90 manufacturing employees located in Bakersfield, the taxpayer would be eligible for the credit.
- While this bill purports to grant a credit to a taxpayer for locating, retaining or expanding a headquarters operation in this state, its technical provisions count research and development elements of a corporations business as headquarters operations.
- This bill would provide a credit only for corporations engaged in multistate or multinational business. Corporations engaged in solely intrastate business in California would not be eligible for the credit.

Implementation Considerations

This credit was originally developed in AB 1313 (1993/94) and was modified by AB 556 (1995/96). The definitions used in the credit were crafted to match the original intent to provide a credit only for the building and personal property associated with headquarters and research and development functions. The later versions of the credit (in AB 556 and this bill) make it appear that the author may intend to provide a credit for a building and personal property in which manufacturing activities are performed. If this is the author's intent, substantial changes should be made to the bill. Department staff is available to assist the author with any necessary amendments.

Technical Considerations

This bill would raise the following technical considerations. Department staff is available to assist the author with any necessary amendments.

- The bill specifies when the term of a lease begins for purposes of determining the eligible costs of qualified real property acquired by a lessee for a transaction that is treated as a sale for income tax purposes (page 11, lines 1 and 2 of the bill). However, the bill does not specify when the term of a lease begins for purposes of the eligible costs of qualified real property acquired by a lessee for a transaction that is not treated as a sale for income tax purposes (page 9, line 23 of the bill).
- The bill uses the undefined term "qualified costs" instead of the term "eligible costs" in places. These references should be changed to refer to "eligible costs" (page 7, line 24, and page 11, line 14).

- The definition of "eligible costs" requires that a cost be capitalized into the basis of the qualified property in order to be an "eligible cost". In the case of the typical "true lease" (defined under the bill as a lease that is not a sale for sales and use tax purposes), qualified costs are as specified, and in certain cases may not include costs which are capitalized. This ambiguity could result in disputes with the taxpayer over whether it is entitled to claim this credit with respect to true lease payments.
- The bill is unclear as to whether the qualified taxpayer can only be the corporate parent for which the headquarters operation is built, purchased, leased, or expanded. Assuming the author's intent is that only the corporate parent may claim this credit (rather than, for example, a related subsidiary that incurs the eligible costs at the building where the corporate parent maintains its headquarters operation), then the definition of "qualified taxpayer" should be clarified.
- The bill's reference to basis within the definition of "eligible costs" refers to Article 2 of Chapter 15 of the Revenue and Taxation Code in its entirety, which includes basis acquired in non-recognition (i.e., currently non-taxable) transactions where the taxpayer's basis is either carried over or substituted. To eliminate the potential for moving the credit (and "eligible costs") to other entities within an affiliated group in non-recognition transactions, it is suggested that the reference to basis be narrowed to "cost basis" as defined in Section 24912 of the Revenue and Taxation Code.
- The definition of the term "recaptured" in the bill (page 13, lines 11 through 17), contains a phrase that provides "that no more eligible costs are paid or incurred." The meaning of this phrase is unclear in this context. However, when read in context with other provisions of the bill it appears that its purpose was to specify that once a nonqualifying event has occurred, the qualified taxpayer is not thereafter entitled to claim the credit for additional costs paid or incurred in subsequent years that would have otherwise been eligible costs under the bill but for the occurrence of the nonqualifying event.

FISCAL IMPACT

Departmental Costs

The department's potential administrative costs associated with this bill are not expected to be significant.

Tax Revenue Estimate

The revenue losses from this bill under the Bank and Corporation Tax Law are projected as follows:

Beginning on or after January 1, 2000 Enactment after June 30, 1999 (in millions)				
1999-00	2000-01	2001-02	2002-03	2003-04
(\$5)	(\$23)	(\$46)	(\$66)	(\$81)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

Revenue losses would depend on the number of corporations qualifying and the amount of tax liability that would be available to apply the credit.

The above estimates were based on total investment by large corporations, obtained from prior years' federal tax schedule 4562. Total investment was then factored down to headquarters' investment using a variety of data sources, including company annual reports, 10k reports, the Census of Manufacturers, and the FTB bank and corporation sample. It was assumed that this bill would lead to an immediate 20% increase in the level of headquarters investment. Once the levels of eligible investment and generated credit were estimated, microsimulation analysis was used to estimate the amount of the credit that would be applied in each year.

BOARD POSITION

Pending.